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Report To The Secretary Of The Air Force

Air Force Does Not Recover All Required Costs Of Modification Kits Sold To Foreign Governments

DOD appropriations continue to subsidize the foreign military sales program because the Air Force has not effectively implemented Department of Defense pricing policies designed to eliminate such subsidies. Significant costs incurred by the Air Force in providing modification kits to foreign governments have not been charged to or recovered from these countries.

The Air Force needs to effectively implement established procedures to ensure full recovery of costs on future sales. The Air Force also needs to identify and bill foreign governments for any undercharges on past sales.

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GAO/PLRD-82-111
AUGUST 27, 1982



UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

PROCUREMENT, LOGISTICS,
AND READINESS DIVISION

3-207981

The Honorable Verne Orr
The Secretary of the Air Force

Dear Mr. Secretary:

This report discusses problems the Air Force is experiencing in implementing Defense pricing policies in the foreign military sales program and shows that many costs incurred in providing modification kits to foreign governments have not been recovered.

We discussed a draft of this report with representatives of the Office of the Secretary of Defense (Comptroller) and the Air Force. Their comments have been incorporated, where appropriate, in the report.

The report contains recommendations to you on pages 14 and 21. As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the House Committee on Government Operations and the Senate Committee on Governmental Affairs not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to the Director, Office of Management and Budget; the Chairmen, House Committee on Government Operations, Senate Committee on Governmental Affairs, and House and Senate Committees on Appropriations and on Armed Services; and the Secretary of Defense.

Sincerely yours,

Donald J. Horan

Donald J. Horan
Director

A

GENERAL ACCOUNTING OFFICE
REPORT TO THE
SECRETARY OF THE AIR FORCE

AIR FORCE DOES NOT RECOVER ALL
REQUIRED COSTS OF MODIFICATION
KITS SOLD TO FOREIGN GOVERNMENTS

D I G E S T

In an earlier review of Air Force management of modification programs, GAO noticed that the Air Force apparently was not charging foreign governments the full costs of modification kits sold under the foreign military sales program. As of April 1982, the Air Force had over \$360 million of undelivered foreign military sales orders for modification programs. GAO made this review to determine whether Air Force procedures and practices ensure recovery of costs and, if not, to identify those costs not being recovered.

GAO found that Department of Defense pricing policies, designed to eliminate subsidies in the foreign military sales program, have not been effectively implemented by the Air Force. Some Air Force regulations and guidelines on pricing are ambiguous and confusing. As a result, many costs incurred in providing modification kits have not been charged to foreign governments. GAO found that:

- One Air Force regulation classifies certain costs as nonrecurring while another regulation classifies those same costs as recurring. As a result, personnel at one air logistics center applied erroneous pricing criteria to modification kits and failed to charge foreign governments for engineering, technical manuals, special testing, and in-house activities. On just one modification sale, the Air Force absorbed over \$123,000 of recurring support costs that should have been billed to foreign governments. (See pp. 5 and 7.)
- Air logistics centers do not have procedures to validate or update prices for modification kits that are installed on foreign-owned equipment undergoing overhaul at Air Force facilities. As a result, only estimated charges are recovered from foreign governments on these type of sales, and these prices are often erroneous. On two sales selected for review, GAO found that one foreign government was undercharged over \$500,000 because estimated, rather than actual, costs were charged. (See pp. 7 to 8.)

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--The Air Force does not have procedures to identify and accumulate costs incurred when modification kits are assembled in-house by Air Force personnel. These type of costs--not being recovered from foreign governments--are for direct labor; transportation, packing, and crating; and use of Government-owned facilities. (See p. 10.)

GAO believes that a major factor contributing to the ambiguous guidance, inadequate procedures, and the resultant undercharges is the fragmented management within the Air Force Logistics Command. Several activities within the Command are involved in developing policy and guidelines, but no specific activity is responsible for ensuring that the guidance is implemented properly. (See p. 13.)

GAO also found that the San Antonio Air Logistics Center did not charge hundreds of thousands of dollars to foreign governments even when clear and concise procedures were provided. For example, when the Air Force adopted a new method for financing foreign military sales in October 1979, the Command provided specific guidelines to the air logistics centers to recover prefunded costs, such as Government-furnished materials. The San Antonio Center misfiled the instruction and did not implement the procedures. GAO informed Center officials of Command procedures and the Center took action to identify and recover previously unbilled costs. GAO also identified, to Center officials, other equipment items being sold to foreign governments that contained significant prefunded costs. By implementing the instruction, the Center will recover an additional \$193,000 on these sales. (See pp. 17 to 18.)

In 1976, and again in 1978, the Air Force Audit Agency told the Command of deficiencies in its procedures for charging in-house costs. But the Command has not corrected them.

GAO believes that significant costs of modification kits sold to foreign governments have not been fully recovered. GAO also believes that, unless the regulations and procedures for pricing these items are revised, undercharges will continue on future sales.

To ensure full recovery of costs on future sales, GAO recommends that the Secretary of the Air Force

- revise and, to the extent practical, consolidate the various regulations and guidelines to bring them in line with Defense pricing policy of full recovery of costs;
- specifically fix responsibility, within the Command, to ensure effective implementation of this policy; and
- effectively implement established procedures at the air logistics centers that will (1) capture and accumulate direct cost data for in-house efforts so that administrative charges can be properly applied and (2) ensure proper pricing for modification kits assembled for installation on foreign-owned equipment being overhauled at Air Force facilities.

To recover costs which have been underbilled on prior sales, GAO recommends that the Secretary of the Air Force direct the Command to:

- Provide the air logistics centers with proper identification of the various recurring costs that should be charged directly, or appropriately allocated, to foreign governments.
- Require the air logistics centers to review their current operating procedures to ensure they are in line with the full recovery policy and to identify and bill foreign governments for any undercharges. Specific areas that should be reviewed by all logistics centers are modification cases under which kits were (1) installed on foreign-owned items being overhauled and (2) assembled at Air Force facilities by Air Force personnel. Specific costs which have not been charged are those for engineering, assembly asset use, transportation, packing, handling, and crating.

In the case of the San Antonio Center, GAO believes additional emphasis is required and recommends that the Secretary of the Air Force direct the Command to require the San Antonio Air Logistics Center to review all:

- Modification shipments made to foreign governments since October 1, 1978, and determine how

much each foreign government was charged for technical publications, and where prices charged deviated from Defense pricing policies, submit revised billings to the foreign governments.

--Modification sales to foreign governments made since October 1, 1978, applying the pricing criteria contained in the Command's quality control program, and where pricing deviations are found, submit corrected billings.

AGENCY COMMENTS

In commenting on a draft of this report, Defense and Air Force officials agreed with all of GAO's recommendations, except one. (See app. II.) They stated that Air Force regulations are not conflicting on pricing guidance and that there is no need for the Air Force to revise and consolidate its various regulations and guidelines and to bring them in line with Defense policy of full cost recovery. GAO believes the report fully supports this recommendation. In fact, the Air Force is in the process of revising its principal regulation on pricing for foreign military sales which, according to Air Force officials, will significantly clarify and expand Air Force guidance on this subject.

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ABBREVIATIONS

AFSC	Air Force Systems Command
AFLC	Air Force Logistics Command
DOD	Department of Defense
FMS	foreign military sales
GAO	General Accounting Office
GFM	Government-furnished material
RDT&E	research, development, test and evaluation

CHAPTER 1

INTRODUCTION

The Air Force sells billions of dollars of military hardware to foreign governments each year under the foreign military sales (FMS) program. These sales are managed primarily through the Air Force Systems Command (AFSC) and the Air Force Logistics Command (AFLC).

AFSC manages sales of new weapons systems (such as aircraft) and the unique equipment and spare parts needed to support such systems during initial operations. AFLC manages sales of out-of-production systems, usually sold from the active Air Force inventory, and equipment and spare parts needed for follow-on support. Both Commands help foreign governments keep these systems and equipment up-to-date through sales of modification programs.

AFSC sells modifications which are usually incorporated on the end item during production. The costs for such modifications are included in the price of the end item. On occasion, however, AFSC purchases and provides modification kits to foreign governments for retrofit on end items. For example, from fiscal years 1978-81, AFSC sold modification kits that amounted to about \$1.5 million.

AFLC generally sells modifications as kits to be installed on operational systems. As of April 1982, FMS undelivered orders on open modification sales cases exceeded \$360 million.

Under most prior agreements between the United States and foreign governments, the Air Force purchased items based on firm orders from foreign governments and those governments reimbursed the United States. Under the reimbursement method, the Air Force initially funds and pays for all costs incurred in the modification program. When the kits are delivered to a foreign government, the Air Force bills the country's trust fund account.

At the start of fiscal year 1980, the Air Force shifted to a direct cite funding concept. Under this concept, most costs incurred in the modification program are to be paid directly from the foreign government's funds. The Air Force prefers the direct cite funding concept and is currently using it. But the reimbursement method is still being used for older cases that are still open.

Prior to the sale of a modification kit, the Air Force estimates the costs expected to be incurred to provide it and places the estimated value on each sales case. However, all costs actually incurred are to be fully recovered, regardless of the funding method used.

Past audit reports have been critical of the Department of Defense (DOD) for not recovering full cost of sales to foreign governments. As a result, DOD recently emphasized to the services the need to recover full cost of sales to foreign governments. In an April 1981 letter to the Secretaries of the military services, the Deputy Secretary of Defense noted that:

"Financial management of the Foreign Military Sales (FMS) program has been the subject of many audit reports. In response, we have concurred in findings and recommendations which were considered valid and indicated that corrective actions would be taken. However, we are still receiving audit reports which indicate continuing problems--especially underbillings--in the FMS area. Most of the recent problems have been attributed to noncompliance with established policies and procedures.

"Less than full recovery of costs when billing foreign customers must be borne by DOD appropriations. In addition, Congress has cut appropriations in the past because of underrecoveries. I am concerned that these cuts not occur in the future."

The letter also noted that procedures must be put in effect that will result in accurate and timely billings.

The problem of full cost recovery identified in prior reports mostly involved sales of spare parts and equipment. During a recent review of Air Force management of modification programs, we found indications of problems that had not been addressed previously and which indicated that the Air Force was not recovering full cost of modification kits sold to foreign governments.

This review addressed the FMS sales practices and procedures for recovering full costs on modification kit sales made by both AFSC and AFLC. For AFSC, we found that charges to foreign governments for modification programs included all costs actually incurred. Charges to foreign governments always included, when applicable,

- a pro rata share of recurring support costs, such as those for contract engineering, engineering data, developing technical publications and manuals, and testing and evaluation;
- the actual contract price of the modification kit; and
- the cost of Government-furnished materiel (GFM), including applicable charges for transportation and related handling cost.

However, this was not the case with AFLC. As discussed in chapters 2 and 3, AFLC practices and procedures do not ensure full recovery of costs incurred in the sale of modification kits.

OBJECTIVE, SCOPE, AND METHODOLOGY

Our objective was to evaluate how effectively AFSC and AFLC manage sales of modification kits under the FMS program. We evaluated the pricing policies, procedures, and practices of both Commands and selected sales cases from each command to test their effectiveness.

We reviewed DOD directives and Air Force policies, regulations, and procedures which govern modification kit management. We also reviewed modification management and FMS pricing policies and practices at two logistics centers--San Antonio at Kelly Air Force Base, Texas, and Oklahoma City at Tinker Air Force Base, Oklahoma.

We concentrated our efforts at the San Antonio Center because of its high volume of sales. From October 1977 through February 1980, total Air Force sales of modification kits amounted to just over \$36 million. Of this, about 43 percent was made by the San Antonio Center. Review efforts at the Oklahoma City Center were limited to determining the methods used to price technical publications, which are included in modification kits, sold to foreign governments.

We also obtained data and discussed FMS pricing at

- the Office of the Secretary of Defense (Comptroller) Washington, D.C.;

- AFLC Headquarters, Wright-Patterson Air Force Base, Dayton, Ohio; and

- AFSC, Aeronautical Systems Division, Wright-Patterson Air Force Base, Dayton, Ohio.

We made our review in accordance with GAO's current "Standards for Audit of Governmental Organizations, Programs, Activities, and Functions."

CHAPTER 2

CURRENT REGULATIONS AND PROCEDURES

DO NOT ENSURE RECOVERY OF ALL REQUIRED COSTS

Some regulations and guidelines issued by AFLC Headquarters provide clear guidance to the air logistics centers for full recovery of costs incurred in providing modification kits. But others are ambiguous and confusing. Ambiguous regulations, together with ineffective procedures followed by at least one center, have resulted in many costs not being charged to foreign governments. Consequently, DOD appropriations continue to subsidize the FMS program.

The Air Force Auditor General reported on these weaknesses in 1976 and 1978. AFLC has taken some action to correct these weaknesses; however, similar problems still exist.

IMPLEMENTING REGULATIONS ON COST RECOVERY CREATE CONFUSION

DOD guidance requires that defense articles sold to foreign governments be priced to recover full contract costs plus applicable surcharges. At the time of our audit, DOD Instruction 2140.1, one of the principal instructions on DOD pricing policy, required, among other things, that certain recurring support costs, such as providing engineering services and GFM, developing technical publications, and testing and evaluation, be recovered as a direct charge to a foreign government when directly related to the production contract from which deliveries are made. This instruction has been superceded by and incorporated, in its entirety, into the FMS Financial Management Manual (DOD Manual 7290.3).

The Air Force has several regulations that complement the intent of DOD instructions by specifically requiring in-house costs be recovered on sales of modification programs to foreign governments. However, the Air Force also has issued instructions that appear to contradict the basic intent of DOD instructions. For example, Air Force Regulation 400-3 includes in its definition of nonrecurring production costs, some cost elements which Air Force Regulation 170-3 classifies as recurring.

Also, an AFLC supplement to regulation 400-3 provides that the costs of Air Force manpower for engineering in-house workload incurred as a result of the foreign sale of modification kits be recouped through administrative charges. Similarly, operating instructions issued by the San Antonio and Oklahoma City Air Logistics Centers provide that the costs of Air Force manpower

incurred as a result of in-house kit assembly will be recovered as part of the administrative charge on the sale. Air Force Regulation 170-3 requires that these type costs be recovered as direct charges.

Ambiguities in these instructions created confusion, at least, at one logistics center--San Antonio. As a result, personnel at that Center have failed to fully recover many costs, such as those for (1) recurring support, (2) modification kits installed on foreign-owned equipment, and (3) other in-house activities. These are discussed below.

RECURRING SUPPORT COSTS ARE
NOT BEING RECOVERED

The classification of certain costs as recurring in one regulation and as nonrecurring in another created confusion at the San Antonio Air Logistics Center. As a result, Center personnel applied erroneous pricing criteria to modification programs sold to foreign governments and excluded all recurring support costs associated with modification kits.

In June 1979, the Center issued local operating instructions to the three divisions with modification management responsibilities. The instructions were to be used for pricing modification kits sold to foreign governments. The instructions emphasized the requirement to apply a dollar threshold to nonrecurring costs, stating that:

"a. Recoupment of nonrecurring costs for USAF products and technology will be made on a pro-rata basis only when any cost category exceeds \$5 million. Three non-recurring categories are applicable: technology; research, development, test and evaluation (RDT&E); and production costs. (Reference definitions in AFR 400-3, chapter 3, paragraphs 3-26le, f and g). When the cost of any of these categories exceeds \$5 million, the cost of all non-recurring categories will be combined and prorated for assessment."

Thus, no such costs were to be recouped until the \$5 million threshold had been reached.

The San Antonio Center also instructed the divisions' modification managers to apply the \$5 million threshold to all nonrecurring costs for modification programs. We found that nonrecurring costs were essentially the same as those that were specified as recurring support costs in DOD Instruction 2140.1.

Division modification managers told us that support costs for an entire modification program applicable to both Air Force and foreign governments generally do not amount to \$5 million.

They stated therefore that the \$5 million threshold policy, in effect, excluded these direct costs from being charged to foreign governments. The significance of these charges is illustrated by the following example.

F-5E egress system
modification

In November 1976, the Air Force initiated a Class IV safety modification for the F-5E egress system. The initial program was established for the 106 F-5E aircraft that were in the Air Force inventory. AFLC assigned management responsibility for the modification program to the San Antonio Center.

In November 1977, the San Antonio Center placed an order against an existing contract with a defense contractor for 106 modification kits which the Air Force needed. In January 1978, the Center ordered an additional 173 modification kits--9 for the Navy, 39 for Jordan, and 125 for Korea. All of these kits were placed on the existing contract, along with the Air Force's requirements, and were delivered and completed by March 1980.

In addition to the purchased kits, the Air Force diverted, to the Government of Yemen, eight modification kits that were already in its inventory, with the understanding that they would be replaced. The replacement kits were delivered to the Air Force in May 1981.

The Governments of Korea, Jordan, and Yemen were charged the actual contract price for the basic modification kits. The Center made no effort to prorate the recurring support costs funded by Air Force appropriations. We requested Center officials to review the contract file and determine the costs that were excluded because of the \$5 million threshold criterion. The table below shows the actual costs paid from Air Force appropriations, but not prorated and shared with the foreign customers.

<u>Costs</u>	<u>Actual cost</u>
Engineering	\$ 82,554
Engineering data charge	4,144
Time compliance technical order	57,388
Manual (technical)	14,303
Manual (training)	6,114
Special tooling	25,727
Kit proofing	<u>15,822</u>
Total	<u>\$206,052</u>

Had a prorated share of these costs been charged, as intended by DOD instructions, the Air Force's cost would have been

substantially reduced. The Air Force absorbed \$123,496 of recurring support costs that should have been billed to Yemen, Jordan, and Korea. The following table shows each recipient's fair share of the cost computed at about \$718 a kit.

<u>Recipient</u>	<u>Quantity of kits</u>	<u>Fair share</u>
Air Force	106	\$ 76,108
Navy	9	6,462
Yemen	8	5,744
Korea	125	89,750
Jordan	39	28,002
Total	287	a/\$206,066

a/ Difference due to rounding.

Other air logistics centers may also be excluding direct cost of modification programs

While our work was generally concentrated at the San Antonio Air Logistics Center, we found indications that other air logistics centers may be having similar problems in interpreting the various Air Force regulations and may not be charging for direct costs. For example, in January 1981, AFLC Headquarters sent the following message to Air Force Headquarters.

"Subject: Recoupment of Non-recurring RDT and E costs to TCTO [time compliance technical order] Mod Kits. The recoupment of non-recurring RDT and E costs incurred as a result of a class IV or V mod which is sold to a foreign country has not been specifically addressed (e.g., C-130, etc). Neither DODI 2140.2 nor chapter 5 of AFR 400-3 state whether or not TCTO modifications fall within the purview of the \$5 million threshold. Since a major systems sale is not involved, it appears that recoupment of non-recurring RDT and E costs should be accomplished without having to apply the \$5 million threshold criteria. Several of the ALCS have expressed the concern that the USG [United States Government] is losing money by excluding these costs and have requested that guidance be provided. Request we be apprised of your determination." (Underscoring added.)

COSTS FOR MODIFICATION KITS
INSTALLED ON FOREIGN-OWNED
EQUIPMENT NOT FULLY RECOVERED

AFLC has a system that permits validating and/or updating prices on modification kits sold and shipped directly to foreign governments. However, the air logistics centers do not have an effective system or procedures to validate and update prices on

modification kits installed on foreign-owned equipment at Air Force facilities. For two cases we reviewed, a foreign government was undercharged over \$500,000 because estimated costs were billed, not actual costs. If the problem identified at the San Antonio Logistics Center exists at the other centers, foreign governments may have been undercharged millions of dollars.

The Air Force billing system for sales under the FMS program is set up to react to modification kit shipments to foreign governments either from a contractor or from Air Force stock. When the system is notified that a modification kit has been shipped, it generates an exception listing which is routed to the appropriate modification kit manager. The kit manager reviews and revises the prices, as necessary, to recover actual costs incurred. The revised listing is returned to billing officials who adjust the billing to reflect actual costs.

We tested this billing system at the San Antonio Air Logistics Center and found that it effectively provided kit managers with listings of shipments so that prices can be validated. However, the system is not used when foreign governments have modification kits installed on their weapon systems and equipment during overhaul at Air Force facilities. In these instances, foreign governments are charged only estimated prices which are often erroneous. For example, on two cases we reviewed, kit prices were mostly erroneous which resulted in the foreign government being undercharged about \$220,000 in actual contract costs and over \$216,000 in other costs. Also, on work in process, an additional \$73,000 could be recovered if actual contract costs are charged instead of estimated costs. Details of these cases follow.

Overhaul of T-56 engines and gearboxes for the Government of Pakistan

Since 1976, the Air Force has overhauled T-56 engines and gearboxes for the Government of Pakistan under two FMS cases. One of the cases, PK-MBK, was completed in May 1981 and involved overhauling 16 engines and gearboxes. The most recent case, PK-MBX, is still in process and will ultimately involve overhauling an additional 16 engines and gearboxes.

For both cases, the Air Force installed four kits on each engine and two kits on each gearbox. Some of the modification kits were already in Air Force inventory, and the remainder was purchased by the San Antonio Air Logistics Center on behalf of the Government of Pakistan. The kits were delivered to and stored at the San Antonio Center until the T-56 engines and gearboxes were available for overhaul. As each engine or gearbox was sent in for overhaul, the needed modification kits were issued to the maintenance activity for installation. After the engines or gearboxes were overhauled and modified, the Government of Pakistan was billed for the costs of the overhaul and the modification kits.

We examined the prices charged to Pakistan for installing the modification kits on the T-56 engines and gearboxes and found significant errors in these prices. For example, only estimated costs were billed, since the Air Force did not have a procedure to validate and/or update the prices to reflect actual contract costs.

The extent of pricing is shown below.

Modification kit No.	Quantity installed	Amount charged to Pakistan	Actual contract cost	Net (under) overcharges
Case PK-MBK				
2840-K0209938ARW	16	\$1,251,072	\$1,274,063	(\$ 22,991)
2840-K0208518ARW	16	244	103,088	(102,844)
2995-K0601719ARW	16	4,623	3,062	1,561
2995-K0208337ARW	16	42	29	13
2840-K0208370ARW	16	1,343	1,343	-
2840-K0208837ARW	16	135,149	94,812	40,337
Subtotal - Case PK-MBK		<u>\$1,392,473</u>	<u>\$1,476,397</u>	<u>(\$ 83,924)</u>
Case PK-MBX				
2840-K0209938ARW	10	\$ 781,920	\$ 863,147	(\$ 81,227)
2840-K0208518ARW	10	152	64,430	(64,278)
2995-K0601719ARW	10	2,890	1,914	976
2995-K0208337ARW	10	27	18	9
2840-K0208370ARW	6	660	504	156
2840-K0208837ARW	6	59,490	51,773	7,717
Subtotal - Case PK-MBX		<u>\$ 845,139</u>	<u>\$ 981,786</u>	<u>(\$136,647)</u>
Total		<u>\$2,237,612</u>	<u>\$2,458,183</u>	<u>(\$220,571)</u>

Upon notification of the undercharges on these two cases, San Antonio Center officials immediately began to rebill the Government of Pakistan, using actual contract costs. As a result, the Center will recover an additional \$220,000 for the

modification kits that have been installed to date. Also, the Air Force is scheduled to overhaul and modify 6 more T-56 engines and 10 more gearboxes under case PK-MBX. If actions are taken to ensure that actual contract prices are charged for installing these remaining kits, the Center will realize an additional \$73,590 in actual contract costs from Pakistan.

The Air Force also omitted other significant costs from the charges to Pakistan, such as a 4-percent charge for using Air Force facilities (asset-use charge) and a 3-percent charge for transportation associated with obtaining the modification kits. When corrective action is taken to recover these costs and the 3-percent administrative charge is applied to the undercharges, the Center will recover an additional \$216,000 from Pakistan.

IN-HOUSE COSTS ARE NOT RECOVERED

Some modification programs sold to foreign governments are designed by Air Force engineers and/or are manufactured and assembled at Air Force facilities by Air Force personnel. On these sales, DOD pricing policies require that all direct and indirect labor costs and related costs be recovered as part of the sale. As noted previously, however, some Air Force regulations conflict with these policies. Also, AFLC has generally ignored the need to establish specific procedures that would allow identification and recovery of these in-house costs.

In January 1976, the Air Force Audit Agency reported to AFLC that procedures were needed to identify and recover these costs. However, AFLC still has not provided effective procedures to do this. As a result, air logistics centers are not charging foreign governments for the direct costs for engineering and kit assembly. Other costs are also not being charged, such as asset-use charges and transportation cost of items obtained from Air Force and other Defense storage sites and sent to an air logistics center for assembly.

DOD instructions identify specific costs to be recovered

Although DOD instructions do not specifically address the sale of modification kits, the language clearly indicates that all direct and indirect costs of sales to foreign governments should be identified and recovered. These instructions state that when manufacturing is performed entirely at a U.S. Government owned and operated facility, direct costs shall include all labor, materiel, and contract costs necessary to accomplish the work. They also state that transportation and related costs, such as packing, handling, and crating, incurred in the movement of materiel and supplies incident to repair and/or modifications will be charged to foreign governments. Packing, handling, and crating

costs are those charges incurred at DOD facilities for labor, materiel, and services, such as picking requisitioned articles from storage locations and preparing them for shipment from storage or distribution points. These costs are incurred on all articles sold from stock to foreign customers. The charges are to be determined at a rate of 3.5 percent of the selling price of material with a unit cost of \$50,000 or less. An additional charge of 1 percent is to be added to that portion of the selling price of material above \$50,000.

Finally, the instructions require that a 4-percent asset-use charge be applied to the direct cost of all FMS cases involving the use of DOD facilities. These charges are to recoup such costs as depreciation, attrition, or damage and interest on investment.

Air Force Audit Agency
criticizes AFLC for not charging
in-house cost on modification kits

The Air Force Audit Agency stated in its followup reports, issued in February and March 1978, that the Ogden and San Antonio Air Logistics Centers were not billing FMS customers for in-house engineering and kit assembly costs. In response to the followup reports, both Centers requested guidance from AFLC.

In October 1978, AFLC distributed a memorandum on FMS modification kit pricing. The memorandum noted that charges for in-house engineering and kit assembly on an individual modification basis would duplicate charges to foreign governments because these costs should be recovered in the administrative charges applied to the sale.

This position was included in the AFLC supplement to Air Force Regulation 400-3 in January 1979. The air logistics centers were, therefore, advised that the cost of Air Force manpower for engineering and other in-house efforts incurred in selling modification kits to foreign governments is recovered through administrative charges.

DOD officials disagree
with AFLC's position

The DOD official primarily responsible for DOD Instruction 2140.1 told us that administrative charges are applied to all FMS cases to recover costs associated and incidental to the sales, such as sales negotiation, case implementation, procurement processing, computer programming and support, and accounting and budgeting functions. He further stated that costs incurred when Air Force personnel assemble the components into a modification kit at Air Force facilities are not administrative costs, but are direct costs that should be identified and recovered from foreign governments on each modification sale.

Foreign governments are not charged
for many costs incurred on modification
kits assembled at Air Force facilities

To determine the effect of AFLC's policy position on in-house costs, we visited the kit assembly section at the San Antonio Air Logistics Center and obtained data on the number of modification kits assembled and sold to foreign governments. We tracked the kits assembled in-house and sold to foreign governments to determine if costs incurred were identified and recovered from the foreign customers.

From October 1979 to April 1981, the San Antonio Logistics Center assembled a total of 400 modification kits on 8 modification programs that were sold to 12 foreign governments. The Air Force recovered \$300,256 on these sales. The prices charged the foreign governments generally reflected only the basic costs of materiel and a token charge for technical publications; other costs were omitted. For example, four of the eight modification programs were designed totally by Air Force engineers, but there was no charge for in-house engineering costs. Similarly, the foreign governments were not charged for direct labor required in the assembly operations. Without the direct labor charge for assembling the kits, the Center did not have the cost data necessary to apply the required 4-percent asset-use charge. Consequently, these charges were not included in the foreign governments' bills. Center personnel included a technical publication in each modification kit, but costs for publications were not charged properly. (Costs for technical publications are discussed in more detail in ch. 3.) Because the Center did not have records showing the extent of costs for personnel, engineering, and assembly operation, we were unable to quantify the extent of undercharges.

We also found that the prices charged to the foreign governments did not include the costs incurred for (1) transporting Air Force inventory items from other air logistics centers to the San Antonio Center for kit assembly and (2) packing, handling, and crating items obtained from other DOD inventories and assembled into the modification kit. We did not attempt to quantify the effect of not charging these costs for all 400 modification kits, but we did obtain data on one shipment of five modification kits.

In December 1979, the San Antonio Center kit assembly section was directed to assemble five modification kits for the Government of Malaysia. The modification kit consisted of one item, a horizontal situation indicator, which was managed by the Oklahoma City Air Logistics Center. Using the Air Force supply system, San Antonio officials requisitioned the horizontal indicators from the Oklahoma City Center.

Upon arrival at San Antonio, the indicators were incorporated into kits, along with a copy of the time compliance technical order. The five kits were shipped to Malaysia in April 1980. After shipment, the Government of Malaysia was billed a total of \$17,619 for the five kits.

The price charged generally reflected the standard price of the indicators (\$3,524 each). Costs for packing, handling, crating, and transporting the indicators from Air Force storage sites to the San Antonio Center were not charged to Malaysia. Using the prescribed Air Force standard rates of 3.75 percent for transportation (2d destination transportation charges) and 3.5 percent for packing, handling, and crating, the Government of Malaysia should have been charged an additional \$1,274 to recover these costs.

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In our opinion, a major factor contributing to the ambiguous guidance, and the resultant undercharges, is the fragmented management within AFLC. For example, the Comptroller's office, Logistics Operations Division, and two groups in the International Logistics Division each provide policy on the FMS program but, in our opinion, do not effectively coordinate their actions with each other. Further, apparently neither of these groups has responsibility for assuring that the policies are implemented effectively. This problem has also been recognized at AFLC, but not solved. In a September 1980 letter to the DOD Director, Supply Management Policy, an AFLC official in Logistics Operations stated that:

"It always amazes me how fractionalized we have made our pricing guidance, if I call a meeting on pricing about twenty people show up. In attendance are my guys on standard pricing, the stock fund people, the representatives from International Logistics and several offices out of DCS/Comptroller. Each has a piece of the action but no single organization has clear responsibility for total pricing policy."

We discussed the problems disclosed by our review with AFLC officials, including representatives from the Comptroller's office, Logistics Operations, and the International Logistics Division. They agreed that problems existed, but no one acknowledged responsibility for them. However, as a result of our discussions, AFLC issued a memorandum in August 1981 to its air logistics centers. AFLC noted that it was taking steps to clarify and standardize guidelines in the pricing of modification kits and identified a number of points that needed to be emphasized or clarified immediately.

CONCLUSIONS

The Air Force is not effectively implementing DOD pricing policies for full recovery of costs applicable to modification kits sold to foreign governments. Certain Air Force regulations and guidelines on pricing policies are confusing. For example, Air Force Regulations 400-3 and 170-3 are inconsistent in the classification of certain costs as recurring or nonrecurring. Also, AFLC instructions require recoupment of certain in-house costs through administrative charges, but Air Force regulations identify those same costs as direct costs to be charged to the foreign governments. In our opinion, AFLC has too many activities involved in developing policies and guidelines, but no activity responsible for ensuring that the policies and guidelines are implemented effectively. Under these conditions, air logistics center personnel are confused and apply erroneous pricing criteria which exclude significant costs in pricing modification kits sold to foreign governments.

Also, the Air Force has not effectively implemented its procedures for updating prices of modification kits installed on foreign-owned equipment being overhauled at Air Force facilities. In these cases, prices charged to foreign governments are based on estimated, rather than actual, costs and significant mispricing occurs.

In 1976, and again in 1978, the Air Force Audit Agency reported, to AFLC, on deficiencies in AFLC procedures for charging in-house costs of modification programs, as required by DOD Instruction 2140.1. But AFLC did not correct them. As a result, many costs which should be reimbursed by foreign governments are being absorbed by Air Force appropriations.

The interim action taken by AFLC in August 1981 to emphasize and clarify certain pricing policies regarding modification kits sold to foreign governments is commendable. However, undercharges will continue on future sales unless the Air Force revises and clarifies its regulations and procedures for pricing these kits.

RECOMMENDATIONS

To ensure recovery of costs on future sales, we recommend that the Secretary of the Air Force

- revise and, to the extent practical, consolidate the various Air Force regulations and guidelines to bring them in line with DOD pricing policy of full recovery of costs;
- specifically fix responsibility, within AFLC, to ensure effective implementation of this policy; and

- effectively implement established procedures at the Air logistics centers that will (1) capture and accumulate direct cost data for in-house efforts so that administrative charges can be applied properly and (2) ensure proper pricing for modification kits assembled for installation on foreign-owned equipment being overhauled at Air Force facilities.

To recover costs which have been underbilled on prior sales, we recommend that the Secretary of the Air Force direct AFLC to:

- Provide the air logistics centers with proper identification of the various recurring costs that should be charged directly or appropriately allocated in charges to foreign governments.
- Require air logistics centers to review their current operational procedures to ensure they are in line with the full recovery policy and to identify and bill foreign governments for any undercharges. Specific areas that should be reviewed by all logistics centers are modification cases under which kits were (1) installed on foreign-owned items being overhauled and (2) assembled at Air Force facilities by Air Force personnel. Specific costs which have not been charged are those for engineering, assembly, asset-use, transportation, packing, handling, and crating.

AGENCY COMMENTS AND OUR EVALUATION

In commenting on a draft of this report, DOD and Air Force officials agreed that there may have been some underbillings but disagreed with our general conclusion that many costs involved in the sale of modification kits are not recovered. According to these officials, some of the costs that we identified as not being recovered, in particular engineering costs, are erroneously identified in the report as recurring costs. They contend these costs should have been recovered as nonrecurring costs under the procedures established in DOD Directive 2140.2, "Recoupment of Nonrecurring Costs on Sales of USG Products and Technology." Briefly, this directive requires that the price of an end item, such as aircraft, include a pro rata share of nonrecurring costs for RDT&E and non-recurring production costs, if it is anticipated that total investment in either of these types of costs will exceed \$5 million. This is referred to as the nonrecurring recoupment charge. Further, these officials contend that costs of developing product improvements, such as Class IV modifications discussed in our report, should be estimated at the outset of a program as part of the nonrecurring production cost pool and should be recovered "up front" as part of the price for the end item. They stated that these costs are recovered by the Aeronautical Systems Division in its weapons systems sales.

We discussed recoupment of these type costs with an Aeronautical Systems Division official at Wright-Patterson Air Force Base, Ohio. That official stated that costs for modification programs, including charges for engineering, data packages, and test and evaluation, are not being recovered as part of the weapons systems sale. He explained that the only nonrecurring charges recovered up front in the price for weapons systems are the RDT&E costs actually expended on the weapons system. That official noted that these costs are easily identified because they are funded by a specific RDT&E appropriation. Finally, that official noted that RDT&E charges have nothing to do with retrofit modification programs that are funded by either Procurement or Operation and Maintenance appropriations.

Thus, while DOD and Air Force procedures may require full cost recovery on DOD weapons and equipment sales to foreign governments, we continue to believe that the procedures confuse those responsible for identifying and accumulating costs associated with sales of modification kits. As a result, the procedures are not implemented effectively within the Air Force and many costs are not recovered.

DOD and Air Force officials agreed with all our recommendations, except one. They stated that Air Force regulations are not conflicting on pricing guidance and that there is no need for the Air Force to revise and consolidate its various regulations and guidelines and to bring them in line with the DOD policy of full cost recovery.

We believe the report fully supports this recommendation. In fact, the Air Force is revising its principal regulation on pricing for foreign military sales which, according to Air Force officials, will significantly clarify and expand Air Force guidance on this subject.

After our discussion with agency personnel, during which the agency's position was provided orally, we received written comments from the agency. (See app. II.)

CHAPTER 3
PREScribed PROCEDURES NOT
IMPLEMENTED OR FOLLOWED AT THE
SAN ANTONIO AIR LOGISTICS CENTER

As previously noted, the lack of clear guidance resulted in less than full recovery of costs. Our review also disclosed that hundreds of thousands of dollars were not recovered from foreign governments even when clear and concise guidelines were provided. For example, AFLC provided the San Antonio Air Logistics Center specific guidance for recovering costs of (1) GFM associated with direct cite funding cases and (2) technical publications. However, the Center did not implement the instruction and did not bill the foreign governments for significant costs. Also, AFLC's recent attempts to assure that contract and related costs of modification kits are fully recovered by providing quality control programs for the centers were not successful because the San Antonio Center did not follow program instructions.

COST OF GFM NOT RECOVERED

Under certain conditions, GFM is provided to contractors for use in the fabrication or repair of end items. When this condition involves the FMS program, DOD instructions and Air Force Regulation 170-3 specifically require that these costs be charged to the foreign government.

Prior to October 1979, most foreign sales managed by the Air Force were financed through the reimbursement method. Under this method, the Air Force paid the costs of needed items and was reimbursed by the foreign government when the items were shipped and billed. In October 1979, the Air Force adopted the direct cite funding concept as the preferred method. Under this authority, all costs are paid, as they are incurred, with the foreign governments' funds.

Under the reimbursement method, Air Force guidelines and procedures effectively identified instances where GFM was involved in modification kits sold to foreign governments. As a result, those costs were recovered.

When the direct cite funding concept was implemented, AFLC recognized that only current cost could be recovered. Other prefunded costs, such as GFM, would have to be billed independently of the contractor's costs. Consequently, in June 1980, AFLC instructed the air logistics centers to manually bill each foreign government's trust fund account for all prefunded costs associated to sales using the direct cite authority.

Our evaluation of modification kits sold to foreign governments using the direct cite concept disclosed that GFM and other prefunded costs were not billed because the San Antonio Center's accounting and finance section misfiled the AFLC instruction and therefore had not implemented the necessary procedure to recover these costs. After we notified San Antonio Center officials of the problem, they promptly implemented the AFLC instruction. Also, San Antonio officials began researching prior billings for modification kits and revising billings to include the GFM cost. At the completion of our review, over \$5,000 of GFM costs had been rebilled on modification kits.

In addition to modification kit sales, we identified other equipment items being purchased with direct cite funds that also contained GFM. We advised Center officials and they agreed to bill the foreign governments in accordance with the AFLC procedure. GFM costs of about \$193,000 will be recovered on these sales.

When we informed AFLC officials of this problem, they contacted each air logistics center to determine if the June 1980 instruction had been implemented. Officials found that all centers, except San Antonio, had properly implemented this instruction.

COST OF TECHNICAL PUBLICATIONS NOT RECOVERED

Since 1978, DOD and Air Force pricing policies on FMS have contained specific guidelines for computing and recovering costs of publications sold to foreign governments. To assure consistent application of these policies, Air Force Headquarters sent a message to each air logistics center outlining the procedures to be followed in determining charges for publications. The pricing policies contained in DOD and Air Force regulations, as well as the special instruction from Air Force Headquarters, were not implemented at the San Antonio Air Logistics Center. Even though each modification kit sold by the San Antonio Center to a foreign government contained a technical publication, in most instances, the foreign government was not charged for the publication. In cases where charges were assessed, the charges were only minimal and did not conform to DOD and Air Force pricing policies.

In April 1978, DOD issued a supplement to DOD Instruction 2140.1 that provided guidance on how to price publications sold to foreign governments. The supplement provides step-by-step instructions on how to develop unit cost for publications, using actual cost data, and cost tables that can be used when actual cost data is not available. For example, as shown in appendix I, one of the cost tables not only requires that a minimum of \$10 be charged for publications but provides specific instructions on how to compute prices for variable quantities.

In September 1978, Air Force Headquarters included the criteria on pricing publications in its Regulation 170-3. The regulation contained the same step-by-step instructions--as did the DOD instruction--on how to develop publication unit costs and charts that could be used for pricing publications when actual cost was not available.

To assure that the new publication pricing criteria were implemented appropriately, Air Force Headquarters initiated a special instruction that was sent to all of the air logistics centers. The special instruction amplified the need to charge the new prescribed prices for publications noting that, at a minimum, foreign governments would be charged \$10 for technical publications.

Each modification kit sold to foreign governments contains an individual technical publication, but the San Antonio Air Logistics Center did not always bill for the publication. Center officials involved in recovering costs on modification programs were not aware of the pricing policies provided in DOD Instruction 2140.1 and in Air Force Regulation 170-3. They were also not aware of the special instruction because it was distributed to an engineering division where it was filed and forgotten.

We evaluated the prices the San Antonio Center charged for each technical publication included in the kits sold to foreign governments. On the modification kits assembled at the Center, costs for technical publications were not charged properly. For example, for the 400 kits assembled at the Center and sold to foreign governments, we found that the technical publication costs recovered on 377 kits were \$592. Had DOD and Air Force policies been implemented properly, foreign governments would have been charged a minimum of \$3,770 for the publications, or an additional \$3,178.

On modification kits purchased through contracts where technical publications were provided as GFM, the San Antonio Center charged foreign governments only token charges of \$2.00 to \$5.00 for each publication. Again, DOD and Air Force pricing policies dictate a minimum charge of \$10 a publication.

While we do not know the full impact of not charging prescribed publication charges at San Antonio, we do know that the Center has sold over 11,500 kits to foreign governments since October 1978, each of which contained a technical publication.

QUALITY CONTROL PROGRAM NOT IMPLEMENTED EFFECTIVELY

AFLC established a quality control program on pricing modification kits sold to foreign governments. The objective was to ensure that modification kit prices charged to foreign governments

were accurate and included all costs incurred by the Air Force in the sale. Air logistics centers were instructed to test, on a sample basis, modification kits sold to foreign governments and to ensure that specific costs were included in the prices charged. The centers were provided a check list to follow to ensure that specific costs were included in the price. Personnel at the San Antonio Center apparently applied the check list in a perfunctory manner and did not identify obvious errors in billings.

Since implementing the program in July 1980, San Antonio officials reported finding no pricing deficiencies in their monthly reports to AFLC. However, our review of some of the modification kit sales that had been subjected to the Center's quality control program indicated otherwise. For example, on one sale, Center officials responsible for conducting the AFLC quality control program overlooked a decimal error in the final price charged to a foreign government, which resulted in the Center underbilling the government over \$215,000. In April 1981, after we informed San Antonio officials of the underbilling, actions were initiated to recover the underbilled amount.

We also found underbillings on modification kit sales subject to the program that resulted from the Center not charging costs previously discussed in this report. For example, we found that billings did not contain costs for

- recurring support (see p. 5);
- technical publications (see p. 18);
- in-house engineering (see p. 10);
- transportation, packing, handling, and
crating for GFM assembled in modification
kits at the Center (see p. 17).

CONCLUSIONS

AFLC's efforts to recover certain costs associated with modification kits sold to foreign governments have been thwarted because of ineffective management at the San Antonio Air Logistics Center. When specific and clear guidelines were provided to the Center on the method to recover cost of GFM and technical publications, the Center misfiled the guidelines and did not act. As a result, thousands of dollars in costs that should have been charged to foreign governments were not. In the case of GFM, the San Antonio Center has begun corrective actions and is rebilling foreign governments. In the case of technical publications, undercharges remain uncollected. When AFLC established a quality control program for air logistics centers to follow in pricing modification kits, the program was not implemented properly by the San Antonio Center. As a result, undercharges in modification kit sales continue.

RECOMMENDATIONS

Recommendations for AFLC action in chapter 2 apply to activities of all air logistics centers. In the case of the San Antonio Center, however, additional emphasis seems to be required. We recommend, therefore, that the Secretary of the Air Force direct AFLC to require the San Antonio Air Logistics Center to specifically review all:

- Modification shipments made to foreign governments since October 1, 1978, and determine how much each foreign government was charged for technical publications. In cases where prices charged deviated from DOD pricing policies, revised billings should be submitted to the foreign government.
- Modification sales to foreign governments made since October 1, 1978, and apply the pricing criteria contained in the AFLC quality control program. In cases where pricing deviations are found, corrective billings should be promptly submitted.

AGENCY COMMENTS

We discussed the problems at the San Antonio Air Logistics Center with cognizant Air Force representatives to obtain official comments. They fully concurred in our conclusions and recommendations and noted that Air Force Headquarters, and in turn AFLC, will reiterate proper pricing guidance to the air logistics centers.

INSTRUCTIONS FOR COMPUTING COSTS
OF TECHNICAL PUBLICATIONS

UNITS	All pubs 100 units or less (note a)
PRICE PER COPY	\$10.00 (based on a 60-unit count average)

UNITS	All pubs over 100 units
PRICE PER COPY	Extrapolate from below

UNITS	1	2	3	4	5	6	7	8	9	10
PRICE (\$)	0.162	0.32	0.49	0.65	0.81	0.97	1.13	1.30	1.46	1.62

UNITS	50	60	70	80	90	100	200	300	400	500
PRICE (\$)	8.00	10.00	11.00	13.00	15.00	16.00	32.00	49.00	65.00	81.00

INSTRUCTIONS

1. Determine unit count of publication.
2. If unit count is at or below the minimum, set price at \$10.00.
3. Extrapolate when unit counts are above the minimum. For example, the calculation for a unit count of 382 would be computed from the table as follows:

	<u>UNITS</u>	<u>PRICE</u>
	300	\$49.00
	80	13.00
	2	.32
Total	382	\$62.32

Rounding to next nearest dollar, the price charged to the FMS customer would be \$62.00.

4. Add 20 percent to price for classified publications.

a/Units equate to pages.



COMPTROLLER

ASSISTANT SECRETARY OF DEFENSE

WASHINGTON D C 20301

9 JUN 1982

Mr. Donald J. Horan
Director, Procurement, Logistics
and Readiness Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Horan:

This is in reply to your May 24, 1982, letter to the Secretary of Defense regarding your draft report, titled: "Air Force Does Not Recover Full Costs of Modification Kits Sold to Foreign Governments," GAO Code 943090 (OSD Case #5987).

Your report states that Department of Defense pricing policies, designed to eliminate subsidies in the Foreign Military Sales program, have not been effectively implemented in Air Force modification programs. As a result, many costs incurred in providing modification kits have not been charged to foreign governments.

Our preliminary evaluation of your report indicated there have been some cases of underbilling for modification kits. However, some of your examples of undercharges involve the development cost of the modification kits which is recovered as a part of the nonrecurring production charge on the end item. The Air Force is reviewing the recovery of the contract and assembly cost of modification kits and publications, and will process billings where such costs have not been recovered.

Specific comments on the reported conditions and your recommendations are contained in the enclosure. With reference to the lack of, or conflicting, policy guidance within the Air Force, your audit covers the time period of late 1980 and early 1981, and many of the problems identified have already been corrected. This is recognized on pages 25 through 32 of your draft report. These improvement actions will be continued.

Sincerely,

John R. Quetsch
Principal Deputy Assistant Secretary of Defense
(Comptroller)

Enclosure

DETAILED COMMENTS ON GAO DRAFT REPORT ENTITLED
"AF DOES NOT RECOVER FULL COSTS OF MODIFICATION KITS
SOLD TO FOREIGN GOVERNMENTS" (OSD CASE 5987) (CODE #943090)

1. Page 2, para 2, line 2: ". . . ~~all~~ most costs incurred"

Not all costs are direct cited to foreign customer funds; e.g., an asset use charge is a reimbursable cost.

2. Page 5, para 1: ". . . ~~DOD~~ OSD HQ"

Use of DOD implies AF HQ was contacted during the survey, which was not the case.

3. Page 6, para 3; page 7, para 1; and page 21, para 1: Although GAO cites DoDI 2140.1, which was current at the time of the audit, it has been superseded by DoD 7290.3-M of June 1981. Specifically, the example given by GAO for recurring support costs of engineering services, testing and evaluation as a direct charge to foreign governments has been deleted and is now recouped as a 1.5% CAS surcharge from foreign customers. Nevertheless, AFR 170-3, the Air Force pricing policy regulation, reiterated the earlier DoDI 2140.1 pricing guidance. GAO contends AFR 400-3, a logistics regulation and an AFLC supplement to AFR 400-3, conflicts with AFR 170-3 on classification of some cost elements. At a meeting between GAO and AF representatives on May 6, 1982, the AF requested the specific regulations' dates and paragraphs where they perceive a conflict. To date, this has not been identified to AF. The AF does not believe there are conflicts. This example does not lend credence to the negative conclusion: "The AF has too many activities involved in developing policies and guidelines" in pricing FMS.

4. Page 9; page 15; page 17; and page 31: We advised GAO that they did not consider DoDD 2140.2 for recouping certain cost elements they contend AF is not recovering. DoDD 2140.2 directs recoupment through a nonrecurring recoupment charge (NRC) of DoD nonrecurring R&D and production investment costs for products and technology where these costs have exceeded \$5M. Investment costs are those RDT&E costs funded by RDT&E appropriation, and nonrecurring production costs (such as production engineering and product improvement) financed by procurement and O&M appropriations for current and future production runs. It follows conceptually that when we determine the NRC for a weapon system sold to a foreign purchaser, most of the nonrecurring costs (in particular in-house engineering of mod kits) identified by GAO in this section of the audit should be a part of the NRC basic calculation for the system being modified. It is important to note that the in-house engineering costs (actual and projected) do not have to cross a \$5M threshold to be considered in the base calculation. The \$5M threshold applies to the total costs of either nonrecurring R&D or production for the life of the system, and once either is breached, all nonrecurring costs are then summed to establish the cost pool for allocation to production quantities. Furthermore, if a system does not meet the \$5M threshold, AF has the option to request an exception from OSD to establish a NRC and recoup these identifiable costs.

5. Page 10 and page 17: With respect to your quotation of statements made by a DoD official, a misunderstanding has occurred. The \$5 million nonrecurring production cost threshold is not normally applicable to modification kits because the threshold is met by the weapons system. Thus, the estimated cost of product improvement (which results in development of modification kits) is included in the nonrecurring charge assessed on the aircraft. There are two categories of nonrecurring costs, nonrecurring research and development (R&D) which is funded by R&D appropriations and nonrecurring production costs which are funded by either Procurement or Operations and Maintenance appropriations. Paragraph III.G, DoD Directive 2140.2, "Recoupment of Nonrecurring Costs on Sales of USG Products and Technology," January 5, 1977, requires that cost of developing product improvements such as the Class IV safety modification for the F-5E egress system cited on page 9 of your report, be recovered as part of nonrecurring production costs. The contractor's value engineering program, another form of product improvement, is recurring and included in contract cost.

6. Page 17, last para: Contract administration is not a cost recovered through the admin surcharge, but is recouped through the 1-1/2% CAS surcharge. Also, costs incurred when AF engineers design a mod program should be captured through the NRC addressed earlier in these comments. Kit assembly is a direct cost to the mod kit sales case.

7. Page 22, para 1: ". . . AF does ~~not~~ have procedures but not implemented for updating prices of mod kits"

GAO agreed to this change during May 6, 1982, meeting.

8. Page 23, para 1:

Recommendation 1 -- Nonconcur. The findings do not support the contention that AF regulations are conflicting on pricing guidance.

Recommendation 2 -- Concur. The responsibility is and has always been fixed at AFLC/AC (Comptroller organization).

Recommendation 3 -- Concur, with exception. Change line 8 to read ". . . -- ~~establish-and-implement~~ ensure procedures are followed at the ALC's" and line 12 to read ". . . for modification kits assembled for installation on foreign owned equipment" GAO agreed to these changes at May 6, 1982 meeting.

9. Page 23, para. 2:

Recommendation 4 -- Concur. AF HQ and, in turn, AFLC, will reiterate proper pricing guidance to the Logistics Centers.

Recommendation 2 -- Concur, with one exception. Change line 4 to read ". . . ~~engineering-and~~ assembly costs" We disagree with the GAO position that the nonrecurring engineering costs would not be recouped. The basis for our position was stated earlier in these comments.

10. Page 32, para 2:

Recommendation 1 -- Concur. The AF will examine the discrete pricing used by the San Antonio Air Logistics Center (page 30, para 2). If publication prices used by the Center were not calculated in accordance with OSD and AF guidelines, then repricing shall be accomplished using the suggested table of publication prices established in OSD and AF pricing instructions.

Recommendation 2 -- Concur in rebilling at the case level for omitted government furnished material and associated costs. However, the recommendation to rebill at the case level for publications (see recommendation 1) may not be cost effective. If AF research supports this conclusion, an equitable charge will be made to the FMS administrative fund rather than to individual FMS cases.

11. Overall Comment: We are concerned about the timeliness of this report due to the fact the field audit work was performed during late 1980-early 1981 timeframe and the conclusions of the audit may not be appropriate for the conditions that exist today.

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